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June 8, 2005

Via electronic filing

Marlene H. Dortch, Secretary
Federal Communications Commission
445 12th Street, NW
Room TW-B204
Washington, DC 20554

Re: Federal-State Joint Board on Universal Service
CC Docket No. 96-45

Dear Madam Secretary:

In accordance with Section 1.1206 of the Commission's rules, 47 CFR §1.1206, I am hereby providing you with notice of an oral *ex parte* presentation in connection with the above-captioned proceeding that took place at a meeting of the Federal-State Joint Board on Universal Service held at the Westin O'Hare Hotel in Rosemont, Illinois on June 7, 2005. The meeting was attended by Commissioner Kathleen Abernathy and (via telephone) by Commissioner Michael Copps of the FCC, Commissioner Tom Dunleavy of the New York State Public Service Commission, Commissioner Robert Nelson of the Michigan Public Service Commission, Commissioner Elliott Smith of the Iowa Utilities Board, Commissioner Ray Baum of the Oregon Public Utility Commission, and Billy Jack Gregg, Director of the West Virginia Consumer Advocate Division. The following staff members also attended: Michelle Carey (FCC, Office of Chairman Martin), Jessica Rosenworcel (FCC, Office of Commissioner Copps), Lauren Belvin (FCC, Office of Commissioner Abernathy), Carl Johnson (NY PSC), Orjiakor Isiogu (Michigan PSC), Peter Bluhm (Vermont PSB), Andrew Margeson (Oregon PUC), Joel Shifman (Maine PUC), Jeff Pursley (Nebraska PSC), Greg Fogleman (Florida PSC, via telephone), Lori Kenyon (Regulatory Commission of Alaska, via telephone), Aram Shumavon (California PUC), Eric Seguin (Oklahoma Corporation Commission), Brad Ramsey (NARUC), David Dowds (Florida PSC, via telephone), Mike Lee (Montana PSC, via telephone), Philip McClelland (Pennsylvania Office of Consumer Advocate, via telephone), Earl Poucher (Florida Office of Public Counsel), Narda Jones (FCC, Telecommunications Access Policy Division (TAPD)), Ted Burmeister (FCC, TAPD), Katie King (FCC, TAPD, via telephone) and Greg Guice (FCC, TAPD, via telephone).

I received a letter dated May 26, 2005 from Andrew S. Fishel, Managing Director of the FCC, inviting me to attend the above-described meeting "on high-cost universal service support for rural carriers." A copy of that letter is attached.

During my initial oral presentation and subsequent discussion with the members of the Joint Board, I addressed the following specific issues:

- I noted as a threshold matter that Sec. 254(b)(3) of the *Telecommunications Act of 1996* provides, specifically, that "*Consumers* in all regions of the Nation, including low-income consumers and those in rural, insular, and high cost areas, should have access to telecommunications and information services, including interexchange services and advanced telecommunications and information services, that are reasonably comparable to those services provided in urban areas and that are available at rates that are reasonably comparable to rates charged for similar services in urban areas" Emphasis supplied. I noted, specifically, the reference to "consumers" rather than to "carriers," and indicated that this section should be interpreted as requiring that consumers in rural, insular and high cost areas should have access to the same types of *competitive* sources of "telecommunications and information services, including interexchange services and advanced telecommunications and information services, that are reasonably comparable to those services provided in urban areas and that are available at rates that are reasonably comparable to rates charged for similar services in urban areas." Policies that favor incumbents over entrants, or that operate to create a market outcome in which survival of the incumbents only is assured, would not be consistent with the requirements of Sec. 254(b)(3) or more generally of the 1996 Act.

- High-cost universal service support for rural carriers should be based upon forward-looking economic cost ("FLEC") developed using a cost model such as the "Synthesis Model" with modifications and enhancements as required to reflect conditions unique to small, rural carriers that may not be fully developed in the existing model.

- The same level of high-cost support per access line – whether based upon the incumbent RLEC's embedded costs (as it is today) or upon FLEC, should be provided to all Eligible Telecommunications Carriers ("ETCs") and Competitive ETCs ("CETCs"). Basing support on each (competing) carrier's own costs – and providing less support to CETCs whose costs are lower than those of the incumbent RLEC – rewards RLEC inefficiency and would work to erase precisely the type of competitive advantage that would otherwise operate to stimulate competitive entry. The Commission has long fostered policies consistent with the principle of technology neutrality, and is currently pursuing this same policy in the ongoing *Intercarrier Compensation NPRM*.

- I noted that claims by RLECs that they would not be able to recover their investment if support were based upon FLEC have been raised on numerous occasions in other contexts by ILECs in attempting to argue against the use of forward-looking costs (e.g., as the basis for setting UNE rates) and in arguing against competitive entry itself, and have all been consistently rejected. I also noted that the "authorized rate of return" applicable to RLEC embedded costs is well in excess of "risk-free" treasury bond rates, and that as such it contemplated the risk of technological obsolescence or other factors creating the possibility that less than all of the RLEC's investment will be recovered.

- I explained that whether high-cost support is based upon embedded cost or FLEC, it is critical that the level of support applicable to any rural carrier be *de-linked* from that company's own costs, and that some cost standard, reflecting efficient operation, be used. I noted that this was the premise behind the FCC's and many States' adoption of "price cap" or other forms of "incentive" regulation in place of traditional rate-of-return regulation ("RORR") beginning the late 1980s and extending into the early 1990s. I explained that the existing system of "cost-plus" support afforded the recipient rural ILEC ("RLEC") no incentive to operate efficiently, since it would be assured full recovery of its costs irrespective of their magnitude or the relative efficiency or inefficiency of the RLEC's operations. I also noted that under this arrangement the RLEC would be made whole with respect to any competitive losses, affording it a formidable advantage over any other entrant.

- I noted that for an *efficient* rural LEC, the principal source of extraordinary cost (vis-a-vis non-rural LECs) is in the area of outside plant, since the costs of most other functions, e.g., switching, customer service, billing, and the various corporate overhead activities, are driven primarily (perhaps even exclusively) by the size of the firm and not by the terrain or density being served. I explained that as such there is no *a priori* basis for high-cost support for any of these functions, since any unusually high costs could be reduced through consolidation among multiple small LECs.

- I explained that the existing support mechanism was actually encouraging larger and more efficient ILECs (including RBOCs) to divest individual rural exchanges so as to make those exchanges eligible for high-cost support, and in so doing to adopt inefficient business models that forgo economies of scale and scope available to larger ILECs and RBOCs in favor of less efficient, small-scale operations. I explained that, for example, the dramatic decreases in transport costs, coupled with the efficiencies of large host/remote digital switch configurations, may be a far more efficient means of serving small, insular communities, affording them the benefits of scale as well as the benefits of remote maintenance and support operations, which would not be available where the wire center continues to be served by its own stand-alone switch. I noted that larger ILECs had been pursuing such wire center consolidation strategies for some time.

- I suggested that only the very smallest ILECs be considered "rural" carriers, and that large holding companies serving hundreds of thousands or more customers should be treated no differently than other large ILECs for purposes of high-cost universal service funding. Moreover, individual exchanges should not become eligible for high-cost support solely by having been divested by a larger ILEC or through balkanization of a holding company group into numerous small affiliates each with its own "study area."

- I suggested a possible interim approach as a means of transitioning to FLEC that would continue to rely upon embedded costs, but de-link the support level from individual RLEC costs by basing support on "best in class" embedded costs. These would be determined, for each major cost category (e.g., outside plant, switching, overhead functions, etc.) by ranking all RLECs from lowest to highest cost-per-line in each cost category, and then using the average per-line cost for the 25% of all RLECs with the lowest costs for that category. I noted that ETI had developed such "best in class" cost estimates for RLEC "overhead" costs in our February 2004 white paper, *Lost in Translation: How Rate of Return Regulation Turned Universal Service Funding for Consumers into Corporate Welfare for the RLECs*.

- Finally, I noted that if the present company-specific embedded cost basis for high-cost support is to be maintained in some form, it is essential that RLECs not be permitted to draw subsidy from the High Cost Fund while at the same time shifting highly profitable lines of business *that utilize the same local service infrastructure and corporate resources* to "below-the-line" status. Such services include, among other things, DSL, Internet access, long distance, and potentially other premium services. RLECs should not be permitted to draw high cost support to fund infrastructure modernization and then proceed to carry revenues from new services made possible thereby "below the line." I noted that shares of publicly traded RLEC holding companies were priced well in excess of book value, indicating that investors perceive these companies, with their high-cost fund revenues, as earning returns well in excess of the "competitive" level that is implied by RORR. RLECs should be required to look to their own revenue sources as support for high-cost areas before being permitted to draw on subsidy funds supplied by consumers in other parts of the country.

I did not present or distribute any documents.

Should you have any questions or require any additional information, please contact the undersigned.

Sincerely,

Lee L. Selwyn

Attachment